1-1-2001

Study on reform of the estate and gift tax system : executive summary

American Institute of Certified Public Accountants. Tax Division

AICPA

American Institute of Certified Public Accountants

Study on Reform of the Estate and Gift Tax System

Executive Summary

February 2001

AICPA Tax Division

NOTICE TO READERS

This Executive Summary is a synopsis of the AICPA's *Study on Reform of the Estate and Gift Tax System*. Tax studies are designed as educational and reference material for the members of the AICPA and others interested in the subject.

The AICPA's *Study on Reform of the Estate and Gift Tax System* is distributed with the understanding that the AICPA is not rendering any tax or legal advice.

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

STUDY ON REFORM OF THE ESTATE AND GIFT TAX SYSTEM

Executive Summary

February 2001

AICPA Tax Division

1 2 3 4 5 6 7 8 9 0 FT 0 9 8 7 6 5 4 3 2 1

Study on
Reform of the Estate and Gift Tax System

EXECUTIVE SUMMARY

Table of Contents

Preface

Although historically the transfer tax system (encompassing the estate, gift and generation-skipping transfer taxes) has been targeted at the very wealthy, and currently affects a small percent of all estates, increasing numbers of taxpayers with moderate wealth are likely to be subject to the tax in the future. In addition, many are concerned over the impact of the transfer tax on estates consisting primarily of small businesses, family farms, and illiquid or inaccessible assets. These escalating concerns have caused most observers to agree that some form of reform to the current system is appropriate. The debate centers on how, not if, the system should be changed.

The American Institute of Certified Public Accountants (AICPA) has undertaken an analysis of a number of changes to the transfer tax system including substantial modifications and outright repeal. With respect to each modification or alternative, the AICPA analyzed its probable impact on taxpayer behavior, complexity and compliance, liquidity, redistribution of wealth, tax and succession planning, revenue, and transition issues.

This study, whose purpose is to educate and enlighten, confirms that significant reform of the U.S. transfer tax system is appropriate and should be undertaken as quickly as possible. In our year-long study, the AICPA has identified a number of significant issues, and the study makes substantive suggestions that the AICPA hopes will be considered in crafting any legislative proposal. We offer our suggestions on each of the alternatives not as a matter of ideology or social policy, but as a result of our collective judgment as to the best way to achieve simplicity, reduce taxpayer compliance burdens, improve ease of administration, and address revenue considerations with respect to the overall tax system.

Acknowledgments

This study was developed as a volunteer effort by the Estate Tax Repeal Task Force of the Trust, Estate, and Gift Tax Technical Resource Panel (TRP) and approved by the Tax Executive Committee of the Tax Division of the American Institute of Certified Public Accountants.

Estate Tax Repeal Task Force

Roby B. Sawyers, *Chair*
Byrle M. Abbin, *Vice-Chair*
Barbara A. Bond
Evelyn M. Capassakis
Robert M. Caplan
John H. Gardner
Ruchika Garga
Brian T. Whitlock

Trust, Estate, and Gift Tax Technical Resource Panel (2000-2001)

Evelyn M. Capassakis, *Chair*
John H. Gardner, *Immediate Past Chair*
Barbara A. Bond
Robert A. Blume
Carol Ann Cantrell
Ruchika Garga
Roger W. Lusby, III
Robert A. Mathers
George L. Strobel, III

Tax Executive Committee (2000-2001)

Pamela J. Pecarich, *Chair*
David A. Lifson, *Immediate Past Chair*
Ward M. Bukofsky
Stephen R. Corrick
Mark H. Ely
Anna C. Fowler
Jill Gansler
Robert L. Goldfarb
Kenneth H. Heller
Diane P. Herndon
Ronald S. Katch
Robert A. Petersen
Jeffrey A. Porter

Acknowledgments

Tax Executive Committee (2000-2001) (continued)

Thomas J. Purcell, III
Jeffrey L. Raymon
Barry D. Roy
Jane T. Rubin
William A. Tate
Claude R. Wilson, Jr.
Robert A. Zarzar

AICPA Tax Division Staff

Gerald W. Padwe, *Vice President - Tax*
Edward S. Karl, *Director*
Eileen R. Sherr, *Technical Manager*
Bonner Menking, *Technical Manager*

Special acknowledgment is given to Jimmy Wilkins of North Carolina State University, Stephen Goldfarb of the AICPA Marketing Services Team, and Elly Filippi of PricewaterhouseCoopers LLP, for their hours and efforts in analyzing and presenting the survey information.

Study on
Reform of the Estate and Gift Tax System

EXECUTIVE SUMMARY

Background

Significant reform of the U.S. transfer tax system has become the topic of much discussion and debate to the point that it is now an important political, social, and economic issue. The current transfer tax system consists of a set of complex laws that apply to estates, gifts, and generation-skipping transfers. These laws are separate and distinct from our income tax system. However, the transfer tax and income tax systems interact with each other in an attempt to achieve overall fairness and congruity in a system of taxation designed both to raise revenue and to achieve various policy goals. Therefore, significant reform of the transfer tax system necessitates an examination of the impact of such transfer tax changes on the income tax system, and how both systems affect complexity, taxpayer compliance burdens, ease of administration, and revenue.

Although historically the transfer tax has been targeted at the very wealthy and currently is paid by less than two percent of all estates, without significant change increasing numbers of taxpayers with moderate wealth will be subject to the tax in the future. Furthermore, huge increases in the value of retirement assets, personal residences, real estate, stock options, and other forms of illiquid or inaccessible wealth have exacerbated the liquidity and tax payment problems, which traditionally, have primarily affected small businesses and farmers.

These factors and others have caused most observers to agree that some form of modification to the current system is appropriate. The debate centers on how, not if, the system should be changed. Congress has considered a variety of approaches to estate tax reform over the last few years. For example, a recent legislative proposal would have reduced transfer tax rates over a ten-year period, followed by a repeal of the transfer tax combined with a new carryover basis regime applied to inherited assets. Although this proposal would have repealed the transfer tax, it would also have increased the complexity and amount of income taxes paid by many heirs. Other proposals would have made relatively minor changes to the transfer tax system, focusing instead on providing targeted relief to farmers and small businesses.

The American Institute of Certified Public Accountants (AICPA) is the national professional association of Certified Public Accountants (CPAs), with more than 350,000 members. Its members practice in public accounting, industry, government, and academia, and represent the full spectrum of political persuasions. As business and financial advisers, and as major participants in the administration of both the income and transfer tax systems, CPAs are uniquely well positioned to contribute to this dialogue from an objective, nonpartisan perspective. Accordingly, the AICPA offers its study and suggestions from the perspectives of simplification, taxpayer compliance burdens, ease of administration, and revenue considerations with respect to the overall tax system, rather than from a particular ideology.

The study first summarizes the current transfer tax system, next gives an overview of the arguments others have made both for and against the transfer tax, and finally describes a variety of possible modifications and alternatives. With respect to each modification or alternative, the AICPA analyzes the probable impacts on taxpayer behavior, complexity and compliance, liquidity, redistribution of wealth, tax and succession planning, revenue, and transition issues, and discusses advantages, concerns, suggestions, and conclusions.

Modifications to the current transfer tax system that are analyzed in the study include:

- Increasing the applicable exclusion amount and changing its structure;
- Altering tax rates and the tax rate structure;
- Increasing targeted relief aimed at small businesses and farms; and
- Extending and modifying liquidity relief provisions.

In addition, the study evaluates four possible alternatives to the current transfer tax system including:

- An immediate or phased-in repeal of the transfer tax, with or without a step-up in income tax basis to fair market value at the date of death;
- A tax on appreciation at death;
- A comprehensive income tax; and
- An accessions tax.

Modifications to the Current Transfer Tax System

Some in Congress have proposed a combination of modifications that include increasing and recharacterizing the applicable exclusion amount, altering the transfer tax rate structure and brackets, expanding payment deferral relief, and modifying the GST tax. Under such an approach, compliance and administrative burdens would be substantially reduced, as most taxpayers would immediately be eliminated from tax filing and payment responsibilities. The overall tax system would be simplified without significant changes to the income tax system (such as a carryover basis regime), and the complexities associated with a gradual transition from one system to another would be avoided. Liquidity problems would be eased through substantial increases in the exclusion amount, significant reductions in tax rates, and the broad application of tax payment deferral options to all estates. Although both Federal and state revenue would be reduced, the estate tax revenue impact would be much less than that resulting from outright repeal.

If the current transfer tax system were modified, the AICPA suggests the following:

- Although the appropriate increase in the applicable exclusion amount depends on Congress' specific goals, increasing the amount to $5 million per taxpayer would eliminate estate tax concerns for 90 to 95 percent of previously taxable estates. Also, the applicable exclusion amount should be indexed annually for inflation.

- The applicable exclusion amount should be made portable (i.e., $10 million per couple), so that any portion unused by the first spouse to die could be utilized by the surviving spouse. Although this can be accomplished under current law through effective tax planning, portability should be made an explicit part of the law.

- Increasing the applicable exclusion amount would necessitate corresponding increases in the $1,060,000 GST tax exemption. In addition, the GST tax should be immediately modified and simplified by including the GST tax modifications passed in several bills by the 106th Congress in any subsequent tax legislation.[1]

- The applicable exclusion amount should be modified so that it becomes a true exemption. Under the present rate structure, this would result in the first dollar of taxable estate facing a marginal tax rate of 18 percent instead of the current 37 percent.

- If the estate tax rate structure is altered, across the board reductions and fewer brackets are preferable to simply reducing the highest marginal rate. In addition to reducing the rates affecting smaller estates, the top marginal rate should be reduced to a rate that is no higher than the maximum individual income tax rate (currently 39.6 percent).

- The AICPA does not support increasing targeted relief under I.R.C. sections 2031(c), 2032A, or 2057, or trying to extend the current liquidity relief measures under I.R.C. section 6166. Targeted relief has not been successful in the past; it treats similarly situated taxpayers differently. The AICPA believes it would be difficult to structure targeted relief in a way that will be useful for taxpayers. In addition, the complexities of section 6166 make it unworkable for many taxpayers. Therefore, the AICPA favors implementing a new regime of broadened liquidity/payment relief measures by eliminating current I.R.C. sections 2031(c), 2032A, 2057, and 6166 and replacing them with broader, simpler provisions available to all taxpayers. If concerned about overuse, the government could limit the attractiveness of such a tax payment deferral regime by adjusting interest rates and the deferral period.

- The full step-up in income tax basis to fair market value for inherited assets should be retained as under current law.

- The state death tax credit should be retained in its current framework, as a credit instead of a deduction, and any revenue losses to the states should be minimized.

These modifications to the existing transfer tax system are directed at solving identified problems and criticisms. A significant concern with this alternative is that modification might not

[1] These GST modifications were previously included in H.R. 2158/S. 1975 of the 106th Congress (The Generation Skipping Transfer Tax Amendments Act of 1999), and the House, Senate (modified version), and conference agreement bills of H.R. 2488 of the 106th Congress (The Financial Freedom Act of 1999), which was passed by Congress, but vetoed by President Clinton. The same GST provisions were included in H.R. 3081 of the 106th Congress (The Wage and Employment Growth Act of 1999). In 2000, the modifications were included in H.R. 3832 of the 106th Congress (The Small Business Tax Fairness Act of 2000), before winding up in H.R. 8 of the 106th Congress (The Death Tax Elimination Act of 2000).

be undertaken in a comprehensive manner or at the suggested levels, thus allowing some or many of the problems to persist and the criticisms to remain. Although comprehensive adoption of the recommended modifications would alleviate taxpayer compliance burdens and administration costs by excluding roughly 95 percent of the taxpayers affected today (leaving only 3,000 or so taxpayers affected by the estate tax), and would not require complex changes to the income tax system, the transfer tax infrastructure would nonetheless remain in place. The existence of that infrastructure could make it easier for future Congresses to expand the impact of the transfer tax system should, for example, revenue pressures demand such a course of action.

Repeal of the Transfer Tax

The new Administration and some members of Congress have proposed complete repeal of the transfer tax. Most proposals would accomplish the repeal through a reduction of top estate tax rates over eight to ten years, with full repeal at the end of the phase-out period. Some proposals would retain the full step-up in income tax basis to fair market value, while others would implement a partial carryover basis regime for inherited assets, effectively increasing income taxes for many taxpayers.

Complete repeal of the estate, gift, and generation-skipping transfer taxes would provide significant estate tax savings for over 48,000 taxpayers who would otherwise pay estate tax, and would reduce compliance burdens for over 100,000 taxpayers who would otherwise file estate and gift tax returns. In addition, estate planning expenses would be reduced for far greater numbers of taxpayers. Liquidity concerns affecting farmers, small businesses, and estates containing other illiquid or inaccessible assets would be eliminated as the incidence of tax would be shifted to the sale or receipt of those assets. The administrative burden and costs incurred by the IRS would also be reduced after the tax is eliminated.

The effect of either immediate repeal or a long-term phase out of the transfer tax on state revenues, Federal revenue, and income tax erosion raises concerns that should be considered and addressed. To simplify a phase-out and immediately remove most taxpayers from filing and payment burdens, the AICPA urges that any phase-out be accomplished by increasing the applicable exclusion amount along with reducing tax rates throughout the rate structure during the phase-out period. Although there are problems in determining and dealing with carryover basis, some of these problems can be avoided by providing a substantial allowance for step-up in income tax basis. Regardless of the method or length of phase-out, it is imperative that the GST tax be modified immediately as was contemplated in previous tax bills.

The AICPA also urges that greater attention be given during the transition period to identifying and implementing those changes necessary to the income tax system before final repeal takes effect.

If the current transfer tax system were repealed, the AICPA suggests the following:

- Although lowering estate tax rates during a phase-out will reduce tax burdens somewhat, it will not reduce the administrative costs of the IRS during the phase-out period. A phase-out of top tax rates also will not appreciably reduce the burden on holders of illiquid assets – such as IRAs and other pension assets, stock options, personal residences, small businesses and farms – during the phase-out period. If a phase-out is appropriate, an increase in the applicable exclusion amount is preferable to phasing in reduced rates because it would reduce the administrative burden to both taxpayers and to the IRS by reducing the number of returns filed.

- The phase-out should be accomplished as expeditiously as possible.

- If a carryover basis regime is implemented, the AICPA suggests that an allowance for step-up in income tax basis also be adopted. This allowance should be substantial in order to avoid the problems inherent in determining carryover basis for the vast majority of estates. In addition, the step-up allowance should be indexed annually for inflation.

- In addition to any general basis step-up, the AICPA suggests that a limited basis step-up for a decedent's principal residence, up to the amount of gain that would have been excluded if the residence were sold immediately before death, be included.

- If a carryover basis regime is implemented, it should include a statutory safe-harbor as an alternative method for determining the basis of lifetime gifts and transfers at death. In some cases, an executor or beneficiary will not have adequate records to calculate carryover basis of assets held at death. A safe-harbor could be tied to inflation rates or other measures of price appreciation, based on historical published prices, or based on a statutorily allowed percentage of fair market value.

- Tax professionals, preparers, beneficiaries, and executors who use a "reasonable" method to determine carryover basis when adequate records do not exist should not be penalized under a carryover basis regime.

- If allowances for basis step-ups are included in a carryover basis regime, an elective safe-harbor procedure should be included for allocating the allowable basis step-up pro rata to all assets and all beneficiaries in a taxable estate.

- After repeal, uniform procedures for how basis information should be communicated to heirs and to the IRS must be established. The AICPA suggests requiring a new information return for reporting the basis of gifts. As under current law, $10,000 annual gifts ($20,000 if gift-splitting is elected) should not require reporting. It is also likely that an information return of some sort would still be required in order to report basis information to heirs. The filing of the information return should also start the running of the statute of limitations.

- Any repeal of the transfer tax presents problems and new issues for the income tax. These issues should be addressed prior to repeal in order to prevent widespread erosion of the income tax, new compliance problems, and new schemes to inappropriately reduce tax burdens after final repeal.

- Donees who have received previously taxed gifts should be allowed to increase their basis in the gifted asset by the entire amount of gift tax paid.

- An automatic, long-term holding period for all inherited assets should be continued as under current law.

- Immediate modifications to the GST tax similar to those included in previous tax bills should be included in any legislation that does not provide for outright and immediate repeal of the estate tax.

Although revenue concerns may necessitate a phase-out of the estate tax rather than immediate repeal, phase-outs result in a great deal of uncertainty, significant transition issues, and additional and costly planning by taxpayers. The AICPA is particularly concerned that the estate tax may not ultimately be fully phased out if Congress is later faced with revenue constraints or increased spending needs. This concern is exacerbated by the possibility that — by the end of a long-term phase-out period — a future Congress may be composed of new members, have changed leadership, and face markedly different challenges than the Congress that approved repeal. In addition, a phase-out of rates provides very little relief during the phase-out period for smaller estates including those containing small businesses, farms, and illiquid assets.

<u>A Tax on Appreciation at Death</u>

The idea of taxing constructive realization of income at death was first proposed in the 1930s and has been resurrected in various forms as recently as 1987. Conceptually, there is no reason why the appreciation on property transferred at death should not be subject to both an income tax on the appreciation and an estate tax on the gratuitous transfer. Practically, if a taxpayer sells appreciated property during his or her lifetime, the gain is subject to income tax, and if the taxpayer transfers the proceeds of the sale (less the income tax paid) at death to his or her heirs, the estate tax will apply also. Therefore, the current step-up in income tax basis at death produces inequities between taxpayers who realize income (appreciation) during life and those who transfer unrealized appreciation at death. Although a tax on appreciation at death has often been referred to by the popular press as a capital gains tax, there is no reason that the appreciation of non-capital assets should escape tax under such a regime. In fact, early proposals suggested taxing the appreciation of all assets.

A tax on appreciation at death is conceptually sound and has the advantage of eliminating the lock-in effect by removing the advantage of holding property until death in order to receive a step-up in income tax basis. A tax on appreciation at death could also raise significant amounts of revenue, particularly if structured with no exemptions and exclusions.

However, an appreciation tax does not address criticisms of the current estate tax related to whether death should be a taxable event. More importantly, an appreciation tax probably would not be feasible without numerous exclusions, exemptions, and targeted relief to address the inherent liquidity problems facing owners of IRAs and other pension assets, real estate, stock options, small businesses, and farms. Even then, it would be difficult to write those exclusions, exemptions and other necessary liquidity relief provisions in a way that would be simple and useful for taxpayers. Consequently, replacing the current estate tax with a tax on appreciation at death does not appear to reduce complexity or taxpayer compliance burdens or ease administration. Although an appreciation tax would reduce the tax burden on many estates by taxing only appreciation and at significantly lower rates than the current estate tax, the distribution of that burden would fall most heavily on small estates.

A Comprehensive Income Tax or an Accessions Tax

In contrast to the current transfer tax or a tax on appreciation at death, which are both assessed on the decedent's estate (the transferor), both a comprehensive income tax and an accessions tax would tax the recipient (transferee) on gifts and bequests received. However, the comprehensive income tax and the accessions tax are separate and distinct modes of taxation. Under a comprehensive income tax, gifts and bequests are included in the recipient's income tax base just as any other item of annual income. By contrast, the accessions tax is essentially an excise tax on the transfer of property by gift or at death. Like the transfer tax, the accessions tax would be assessed on cumulative lifetime gifts and bequests using a graduated tax rate structure. Under most accessions tax proposals, there would be a dual tax rate schedule based on the closeness or remoteness of the transferor to the taxable recipient – with lower rates applying to gifts and bequests from immediate family members and higher rates applying to gifts and bequests from more distant family and unrelated individuals.

Although an accessions tax would completely eliminate the current transfer tax system, the benefit of its elimination would only be received at the cost of developing a new and complex system to replace it. On the other hand, a comprehensive income tax could be integrated with our present income tax system. This could simplify the overall income tax system if the plethora of exclusions and exemptions allowed in our current income tax system were repealed. A comprehensive income tax could also generate significant increases in revenue.

Neither the comprehensive income tax nor the accessions tax have been recently proposed as a viable alternative to our current transfer tax system. Most commentators conclude that their problems outweigh their benefits. Both are completely new systems that would require significant investments of time and money by taxpayers, tax advisers, and the government. Although a comprehensive income tax could simplify the overall income tax system if structured appropriately, it would only be feasible with a number of exclusions and exemptions that would increase its complexity. These taxes do little to alleviate liquidity problems caused by the current transfer tax regime and would be politically difficult to implement due to the change in imposition of the tax from transferor to transferee.

A more elaborate analysis of the transfer tax system and the AICPA's suggestions regarding reform is contained in the complete report.

www.aicpa.org